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TAGS: ETRD EPET ENRG PGOV VZ HO
SUBJECT: (S) HONDURAS UNDER CAFTA: AFTER SIX MONTHS,
LITTLE TO SHOW

Classified By: Ambassador Charles A. Ford for reasons 1.4 (b) and (d)

¶1. (S) Summary: Six months have passed since CAFTA entered into force for Honduras. President Zelaya's support was key to getting Honduras on board, and he continues to profess his support for capitalism and free markets. Yet when faced with making the reforms necessary to let a free market develop, the GOH has too often resorted instead to policies that favor state intervention, protection, and the entrenched elites. This cable considers recent examples from a wide-range of economic sectors, and asks whether Honduras is really taking advantage of the opportunity (and challenge) presented by CAFTA. The record is mixed, but in the matters of most consequence tends towards the negative. On paper Honduras is in an excellent position for strong future growth. In reality, the GOH is coasting on the previous administration's economic successes, and unless the Zelaya administration can generate its own momentum for reform, it risks squandering one of its best-ever opportunities to pull itself up out of poverty. End Summary.

¶2. (S) The Central American Free Trade Agreement (CAFTA) entered into force for Honduras on April 1, 2006, following several months of break-neck legislative and regulatory reform by the GOH. Starting in meetings during the transition period after winning the Presidency on November 26, 2005, Jose Manuel "Mel" Zelaya Rosales made it clear that CAFTA's entry into force was one of his top priorities. New to the realm of international trade agreements, Zelaya questioned grace periods included in CAFTA for sensitive products, and instead expressed his preference for moving Honduras immediately to fully competitive markets. At the time, Post did not doubt the genuineness or depth of Zelaya's dedication to the overarching principle of free trade. To Post's consternation, however, in each significant individual decision since entry into force, the GOH has chosen the more protectionist, less market-oriented solution to economic challenges. Those GOH agencies and leaders eager to move forward with positive, market-oriented reforms are hindered by budgetary inertia and intra-governmental disorganization. Post does not doubt Zelaya's personal dedication to the ideal of competition, but we question whether he fully understands what steps are needed to move towards such an outcome and whether he has the political will to make such steps a

reality.

¶3. (U) The following is an illustrative list of significant economic developments over the first six months of CAFTA. Most have been reported extensively septels, and will only be summarized here.

The Good News: Some Pro-CAFTA Reforms

¶4. (SBU) Intellectual Property Rights (IPR): GOH efforts on IPR have tended to run hot and cold, but under CAFTA the GOH has nevertheless made significant advances that, if continued, should help spur investment. CAFTA restored ex-oficio powers to Honduran law enforcement, freeing them to crack down on pirates even without specific complaints being filed by the aggrieved party (often a major multinational with little time for filing the paperwork to justify each individual raid). The IPR prosecutor's office has enthusiastically participated in several U.S. Patent and Trademark Office (USPTO) training sessions, and has launched a few high-profile raids on pirated DVD and CD vendors. The GOH has adopted a proactive IPR strategy (with significant behind-the-scenes input from Post) and the Vice President himself has adopted it as one of his issues. Effective enforcement is still well in the future, and is significantly undermined by a dysfunctional judiciary, but the GOH deserves praise for its energetic first steps to come to grips with the IPR challenge.

¶5. (S) Puerto Cortes: As the only significant deep water port in the region and the anchor for a regional export strategy, Puerto Cortes is a major competitive advantage for

Honduras. Its 2004 self-certification to the International Maritime Organization, followed by kudos from the U.S. Coast Guard and selection for the Container Security and Megaports Initiatives, all mark the port as a major success. On the downside, the port has had three non-technical directors in nine months and suffers from endemic corruption and relative inefficiency. The newly named director of ports, Edwin Araque (former Deputy President of the Central Bank) told Post privately that his job is to confront the entrenched corruption. In particular, he has been tasked with reducing the corrosive influence wielded by Marco Avila, a major Zelaya campaign contributor with a dark past. Avila brags that he controls the port, and through his monopoly on cranes there he reportedly extorts funds from port users. Araque claims Zelaya knows Avila must be confronted but since Avila was a significant campaign contributor Zelaya does not want to be in the forefront of such an effort. Araque recognizes that he risks his life with this task, and Post will seek ways to support him in his efforts.

¶6. (SBU) Road Infrastructure: Closely related to the developmental impact of the Port is improving the road system to link the port to internal markets and to markets in neighboring Nicaragua, Guatemala, and El Salvador. The previous GOH administration explicitly recognized this by making roads improvement the centerpiece of its Millennium Challenge compact. The new administration, while recognizing the importance of roads, has suffered from very slow project execution. The GOH has reluctantly accepted the necessity of funding road operations and maintenance (having been forced to do so as a conditionality under the MCC compact). The comprehensive nature of the roads project under the MCC includes elements to improve transparency, accountability, evaluation, and sustainability over the long-term. It is hoped that success of this project will lead the GOH to adopt similar rigor in future infrastructure projects. The highway project will be critical to the success of exploiting new market opportunities under CAFTA, and adopting these best practices for future project will be the key to sustainable growth for Honduras in the future.

¶7. (SBU) Banking: The Honduran banking sector is another bright spot, as local banks slowly gear themselves up for the faster and more competitive regional and global markets that CAFTA will bring. As Honduran trade and investment prepares to expand under CAFTA, regional banks have taken notice and aggressively entered the market. Under threat, the Honduran banking sector is looking for ways to compete. While still conservative to a fault, the banking sector has begun to reorient its attitudes towards more creative products and services. Lack of access to credit has always been one of the biggest barriers to entry and expansion for would-be Honduran small and medium enterprises. As the banking sector is weaned from dependence on government bonds, Post hopes to see credit to the private sector expand accordingly. Mortgage credit has already seen impressive growth, led by the regional banks. The Honduran banks have a long way to go, but have at last apparently faced the reality of the emerging competition. The GOH for its part embarked last year on a comprehensive set of banking sector regulatory reforms designed to bring the sector (eventually) up to Basel II standards. GOH cooperation on anti-money-laundering has been outstanding, and ongoing efforts to reform the seized-assets office will only further strengthen these results.

Other Policies Are Major Steps Backwards

¶8. (S) Energy: By far the most worrisome development has been the post-CAFTA decision by the GOH to nationalize the importation of all fuels into the country. This non-transparent process threatens to strip existing U.S. investors of their rights to participate in the sector, and could effectively strand millions of dollars in investments and force breach of contracts with suppliers and distributors. The GOH explains the creation of a state-run

monopoly by claiming that it is a justifiable response to an alleged oligopoly, and that it is (bizarrely) a step on the road to liberalization of the sector. Post assesses that our aggressive public and private interventions have significantly reduced the chances that this process will result in a political and economic alliance of the GOH with Venezuela under a PetroCaribe arrangement. We also assess that we have largely stymied early attempts by politically influential powers (including former President Rafael Leonardo Callejas) to corruptly manipulate and personally profit from this scheme. Despite these victories, Post still views the nationalization plan as profoundly misguided and likely non-compliant with CAFTA. Depending how it is implemented, the damage from this scheme, and from the predicted follow-on lawsuits, could dramatically chill the investment climate here and set back by years Honduran efforts to spur investment-led growth and job creation. With this one stroke, Honduras could lose the good will attained by joining CAFTA, while also calling into question the depth of its dedication to basic free-market principles.

¶9. (S) Presidential Meetings: In private meetings with Ambassador, President Zelaya reiterates to his commitment to market reforms, but in public he contradicts himself. On two occasions (June and September 2006) President Zelaya has met with POTUS. Despite POTUS's counsel that POTUS did not understand how the fuel import scheme could work and that, were it his choice, he would not pursue it, Zelaya remains unswayed. In a move that demonstrated lack of finesse and his reported bull-headed streak, President Zelaya exited each of the POTUS meetings publicly declaring that POTUS supported his plans, including the fuel scheme. On both occasions Post was forced to issue statements correcting the record. Post is concerned that despite receiving a strong message from the most senior level of the USG, Zelaya has failed to moderate his rhetoric or alter his plan. Indeed, Zelaya went even

further in a September 19 speech to the United Nations General Assembly, in which he used phrases evocative of the 1970s to blast free markets. Post is at something of a loss as to how to explain Zelaya's apparent cognitive dissonance between supporting free trade as a concept and yet calling for a government nationalization and monopolization of the fuel imports sector.

¶10. (C) Mining: In the mining sector, the GOH has moved to ban open-pit mining for precious metals, alleging environmental damages. A 'temporary' ban on new mining permits has been in effect since July 2004, but with no attendant movement towards a serious review of GOH processes and procedures to protect the environment. Most precious metals mining in Honduras is conducted by foreign firms (including at least two U.S. firms), while most open pit mining for sand, gravel, and other resources -- excluded from the proposed ban -- is conducted by Honduran firms. It is unclear whether the intent of the ban is to target foreign firms, to open space for Honduran investors to perhaps take-over lucrative precious metals mines, or whether the GOH is, as it claims, primarily motivated by concerns over the use of cyanide and other chemicals in gold and silver mining operations. If the latter, a far more appropriate and targeted response would be improved environmental regulation, not a ban. Nevertheless, the ban will likely go into effect, as there is no political will on either side of the aisle to stop it. When it does, existing mines will be grandfathered, but expansions or new investments will almost certainly cease, effectively closing off this sector to foreign investment.

¶11. (C) Food Security: The GOH has altered for the worse its agricultural policies, moving away from proven successful methods of diversification into higher value added crops and toward subsidies for uneconomic basic grains. This is not an obvious breach of CAFTA, but it is a significant step backwards from sustainable economic development policies for a country where 50 percent of the workforce is still on small and subsistence farms. CAFTA is a tool to spur development, but it cannot do so without appropriate GOH policies to support it. The GOH's return to discredited statist policies

of the past, subsidizing non-competitive crops, calls into question its will to challenge the traditional (but failed) agricultural model. Worse, to fund these crop subsidies, the GOH plundered the agricultural sector budget, robbing funds from technical assistance programs, crop diversification programs, and even proposing to zero-out animal health programs, likely with expectations that donors would fill in the funding gaps. This last cut would have left Honduras woefully unprotected against avian flu, and also unable to meet the sanitary standards needed to increase food exports to the U.S., again undermining one of the key benefits of CAFTA. Post succeeded in getting the GOH to restore funding for the animal health inspection program, but we remain deeply concerned by the instinct that allowed the GOH to think such proposed cuts were ever a good idea.

¶12. (C) Telecommunications: The long-awaited telecommunications reform bills remain stalled, as protectionist elements seek to preserve inefficient and bloated parastatal telephone company Hondutel. A draft 2005 bill was watered down and loaded up with pro-Hondutel and anti-free market provisions by the new Congress, and debate since then has largely centered on removing these objectionable articles. The bill has been split into two, one to liberalize the sector and the other to strengthen Hondutel. It is generally accepted that politically the two must pass at the same time if they are to pass at all. Honduran telecomms are reportedly CAFTA compliant now, thanks to a series of administrative decrees issued by the previous administration in late 2005. However, the pending bill would formalize and lock-in those changes, and would set the stage for greater market opening. For the time being, a number of

investors (including U.S. investors) remain in limbo, promised a chance to compete on an equal footing but not yet given that chance. Post is cautiously optimistic a bill will pass this year, though GOH Chief CAFTA Negotiator Melvin Redondo recently told Post that he fears the current version of the bill does not go far enough and might not be fully CAFTA compliant. Post continues to watch this closely.

¶13. (SBU) Fiscal Policy: While not a formal part of CAFTA, a responsible fiscal policy is a necessary enabling element to the investment and growth CAFTA seeks to generate in Honduras. There are signs the GOH fiscal discipline has eroded during the Zelaya Administration, culminating with the International Monetary Fund (IMF) failing to close its latest Poverty Reduction and Growth Facility (PRGF) review of Honduras, implying significant fiscal problems were discovered. Deteriorating fiscal conditions or weaker Fund confidence in the GOH could cool investors on Honduras by increasing the perception (or reality) of investor risk. Another fiscal factor that more directly impacts investment is the GOH's under-execution of capital investment programs. Many of these programs relate to infrastructure, which directly supports economic activity and increased trade. Until the GOH can organize itself to begin disbursing effectively on these programs, the slowed construction will likely result in slower investment and trade than would otherwise have been the case.

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Disorganization, Lack of Resources Magnify Challenges
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¶14. (C) The Competition Commission: One of the successes of the early Zelaya Administration was passage of Honduras' first bill outlawing monopolistic market practices and unfair competition and establishing a Honduran Competition Commission (an anti-trust body, much like the U.S. Federal Trade Commission.) The legislation, under consideration since 1992, was finally passed in February 2006. Unfortunately, since then the GOH has demonstrated indications of lack of will to make this body effective by delaying any further action for months, and then proposing as one of three Commissioners the Chief Operating Officer of the cement monopoly. (Note: Minister of the Presidency Yani Rosenthal is President of that cement company. End Note.) Outcry from several quarters, including a strong intervention

by Post with the President himself, forced withdrawal of the list. Following another two months of dithering, the Honduran Congress named three acceptable commissioners, but the decree formalizing their nomination remains unsigned on the President's desk two months later. In the meantime, the GOH has proposed to fund the Commission at only 60 percent of its minimum estimated start-up costs, dramatically decreasing the likelihood the Commission can be made effective by the December 2006 target date. Until a budget is approved, the Commission has no access to any funds, meaning it cannot hire staff or ramp up activities to meet its legal mandates. While the Ministry of Finance focuses on other fiscal crises, funding other important initiatives lags. In the meantime, monopolistic and crony-capitalist business practices continue to hamper economic development.

¶15. (C) Foreign Trade Institute: The Ministry of Commerce has yet to produce a comprehensive CAFTA implementation plan for Honduras, as illustrated by its failure to launch the legislatively-mandated Foreign Trade Institute. This organ, designed to have been the central authority for the GOH to administer CAFTA, has yet to be formed or funded. The institute was intended in part to retain the expertise of trade experts and negotiators, and to ensure the GOH had a critical mass of experts to implement CAFTA effectively. Lacking budget support and regulatory authority, the GOH announced in April that it would delay formation of the Institute until October. As October begins, there is little

sign the GOH is prepared yet to launch the body. Early in the administration, Vice Minister of Trade and Industry Jorge "Coki" Rosa made public remarks opposing the Institute, remarks he was subsequently forced to retract. In private conversations with Post, however, he blamed the failure to establish the Institute on the Minister. Meanwhile, Minister Azcona claims that there are problems with the hiring procedures laid out by the legislation, a claim refuted by the private sector, which views her claims as stall tactics meant to limit private sector oversight of the Institute, as written its founding legislation.

¶16. (S) More recently, Rosa has intimated that his price for support of the project would be setting up the Institute as an independent organ, outside the Ministry of Trade, with himself as its head and carrying the rank of Minister. (Comment: This would be a disaster, as Rosa appears concerned about his own advancement and that of his Liberal Party above all else. Following a two hour presentation on the need for effective consumer protection, for example, Rosa's sole question to the presenters was how many Liberal Party members the new organ would hire. In another example, Rosa backed India's very unhelpful proposal on renewable energy technology at the recent World Trade Organization talks, dismissing the U.S. proposal as containing "nothing" of interest to Honduras. End Comment.) The Minister and Vice Minister are reportedly not on speaking terms, further exacerbating the GOH's weak follow-through in developing CAFTA implementation strategies.

Corruption and Lack of Juridical Security

¶17. (SBU) Corruption/juridical security: Casting a pall over every other aspect of doing business in Honduras is a clear and disturbing lack of juridical security. Cited almost universally as the greatest impediment to investment here (even more than physical security), this pervasive corruption and lack of rule of law undermines every contract. Land titles cannot be trusted, which not only increases costs and slows the process of building a plant, but also complicates access to credit as banks are wary of using such titles as collateral. Rights and guarantees, such as patents and trademarks, are ephemeral, and Post is aware of cases in which registrations have vanished from the registries, permitting other firms to register infringing marks. Official decisions can be arbitrary, and public officials including judges are susceptible to both bribery and other forms of influence or pressure. Even when caught, there is

rarely any sanction imposed on corrupt public officials. While official immunity was eliminated last year, official impunity remains the acknowledged standard.

¶18. (C) Juridical security continued: Finally, there is a perception if not a reality that Honduran parties to lawsuits receive unfair advantage versus foreign parties. For example, a U.S. mining company is being assessed a three million dollar judgment as the result of a case to which they are not even party, and in which the culpable party was determined to be the GOH itself. In another case, a worker fired for cause was nevertheless awarded punitive damages from the U.S. employer. He is now suing the firm's affiliate company -- for which he never worked -- for back wages and additional damages. In a third recent case, when workers for a small Honduran apparel plant failed to win punitive damages from the firm, they sued the big U.S. firm to which the Honduran firm sold its products as a subcontractor. Despite having nothing to do with the case (other than buying its products), the U.S. firm is potentially facing 2.5 million dollars in damages to another company's workers. As a result of its treatment in this case, the U.S. firm -- which employs 3000 Hondurans -- is contemplating pulling out of Honduras.

Comment

¶19. (S) Comment: President Zelaya repeatedly professes his support for capitalism and free markets. Yet when faced with making the reforms necessary to let a free market develop, the GOH has too often resorted instead to discredited policies that favor state intervention, protection, and the entrenched elites. As can be seen from the above list, the record is mixed, but in the matters of most consequence tends towards the negative. Under the previous administration, Honduras spent four years building a solid macro economic foundation, securing debt relief, and winning approval of CAFTA. Its economy is growing, its currency is stable, and inflation is under control. Yet the policies of the new administration, while benefiting from this historical momentum, do not seem to build on and expand these trends. Zelaya's populist tendencies have left him unwilling to confront interest groups (such as teachers) in promoting needed reforms, and all too willing to buy his way out of social confrontation though unsustainable state subsidies. This focus on the short-term, and on popular but largely unproductive subsidies of consumption, limits Honduras, ability to invest in true market reforming initiatives. Such reforms could position Honduras to better take advantage of CAFTA by laying solid foundations for economic expansion. On paper Honduras is in an excellent position for strong future growth. In reality, the GOH is coasting on the previous administration's successes, and unless it can generate its own momentum for reform, it risks squandering one of its best-ever opportunities to pull itself up out of poverty. End Comment.

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